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REGULATING THE FILM INDUSTRY IN CHINA: A NEW APPROACH

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For U.S. filmmakers, the People's Republic of China represents a prodigious market opportunity. Yet, true exploitation of the market is simply chimerical due to an obstinate web of import quotas, censorship, and government intervention, all founded upon a guise of cultural protectionism. Brian R. Byrne argues that: (i) China's authoritarian approach to film distribution, coupled with its deficient intellectual property regime, actually promotes the dissemination of Western culture within its borders – a direct perversion of its intentions; and (ii) in order to achieve its cultural objectives, China must undertake a number of key reforms.

I. INTRODUCTION

For U.S. filmmakers, the People's Republic of China represents a prodigious market opportunity.[1] As the Chinese middle-class expands,[2] enjoying an increase

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[1] Chinese box office sales reached $907 million in 2009, representing a 42 percent growth in the sector. *See Zhang Yimou: China Needs More Cinemas,* Beijing Review, Mar. 8 2010, *available at* http://www.bjreview.com.cn/movies/txt/2010-03/08/content_252286.htm.

[2] *See* Wayne M. Morrison, Cong. Research Serv., RL 33536, China-US Trade Issues 1 (2009).

in disposable income,[3] the thirst for quality entertainment intensifies.[4] Cinema construction rampages across the mainland in an effort to satisfy demand for theatrical releases.[5] Yet despite this consumer demand,[6] supply methodology remains a perplexing phenomenon. True exploitation of the market is simply chimerical due to an obstinate web of import quotas, censorship, and government intervention, all founded upon a guise of cultural protectionism.[7]

However, notwithstanding the obstacles to legitimate distribution, the channels of illegitimate distribution remain relatively unencumbered. Piracy is rampant throughout China[8] and high quality copies of pirated films are widely available, often before the film in question has even been released through lawful channels. Moreover, in contrast to lawful distribution, pirates are subject to neither an import quota nor the rigorous censorship regime that would otherwise apply.[9] Thus, China appears to offer a distinct advantage to illegitimate market players.

Unsurprisingly, this regime has caused diplomatic unrest,[10] souring, in particular, China's relationship with the United States. In 2007, the U.S. initiated

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[3] For a detailed economic analysis of the Chinese middle class' spending power, *see* Diana Farrell et al, *The Value of China's Emerging Middle Class,* McKinsey Quarterly, Spec. Ed. 2006, at 60, 69.

[4] *See* Patrick H. Hu, *Mickey Mouse in China: Legal and Cultural Implications in Protecting U.S. Copyrights*, 14 B.U. Int'l L.J. 81, 92 (1996).

[5] It has been reported that 626 screens were added last year bringing China's screen total to 4,723 by the end of 2009. This represents an increase of 13 percent. Ding Wenlei, *Building China's Hollywood*, Beijing Review, Feb. 18, 2010, *available at* http://www.bjreview.com.cn/business/txt/2010-02/11/content_246761.htm.

[6] Acclaimed Chinese director Zhang Yimou recently proposed to the Chinese People's Political Consultative Conference (CPPCC) that more cinemas should be built in smaller towns and cities to satisfy demand. *Zhang Yimou: China Needs More Cinemas*, *supra* note 1.

[7] *See* Panel Report, *China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, ¶ 7.709, WT/DS363/R (Aug. 12, 2009).

[8] Some reports indicate that 95 percent of all movies sold in China are pirated. *See* Frank Lin, *Piracy in China: Identifying the Problem and Implementing Solutions,* 14 Currents: Int'l Trade L. J. 83, 89 (2005). Others indicate a rate of 90 percent. *See* Kevin Lee, *The Little State Department: Hollywood and the MPAA's Influence on U.S. Trade Relations,* 28. Nw. J. Int'l L. & Bus. 371, 389 (2008).

[9] *See* Paula M. Miller, *Reeling in China's Movie Fans,* China Business Review, Mar./Apr. 2007 35, 37.

[10] Senator Chuck Schumer blasted China in the media in 2007 and hailed the WTO complaints, saying, "China has no excuse to allow American intellectual property to be ripped off without any consequences. I hope this is just the beginning of a much stronger

two WTO proceedings against China, one regarding insufficient protection of intellectual property,[11] and the other complaining of insufficient market access.[12] In both instances, the Panels made rulings adverse to China. In the aftermath of these decisions, China faces deep scrutiny from the international community and an expectation that the necessary reforms will be implemented.

This paper will not serve to deconstruct the WTO rulings. Rather, I will argue that: (i) China's authoritarian approach to film distribution, coupled with its deficient intellectual property regime, actually promotes the dissemination of Western culture within its borders – a direct perversion of its intentions; and (ii) in order to achieve its cultural objectives, China must undertake a number of key reforms.

II. Film Distribution in China and the Control of Culture

Before proposing a new market structure, I will examine the structure currently in place, emphasizing the market valves and barriers that China has implemented to maintain cultural oversight.

The system for distributing U.S. films in China has been described as "among the most burdensome and restrictive in the world."[13] In order to release a film in Chinese theaters, foreign studios must overcome a number of significant obstacles, each one carrying the potential to reduce or even eviscerate potential profits. After analyzing each of these impediments, I will turn to the perverse result of this structure.

(a) Importation and Distribution

The theatrical release of foreign films in China is heavily restricted and state-governed. Regulatory oversight is vested in China's State Administration on

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Administration stance on China's nonstop violations of free trade rules." *See* Eric Bangeman, *US Says China Isn't Doing Enough About Piracy, Files Complaint with WTO*, Ars Technica (Apr. 10, 2007), http://arstechnica.com/tech-policy/news/2007/04/us-says-china-isnt-doing-enough-about-piracy-files-complaint-with-wto.ars.

[11] *See* Panel Report, *China – Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, WT/DS362/R (Jan. 26, 2009).

[12] *See China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products,supra* note 7.

[13] Bradley S. Klapper, *WTO Win Could Open China's Doors to US Companies*, Arizona Daily Sun, Aug. 12, 2009, *available at* http://azdailysun.com/news/article_80c41a2e-f8ce-50cd-8b7f-141ff30a9aa3.html (quoting Dan Glickman, MPAA Chairman).

Radio, Film and Television (the SARFT).[14] Only twenty foreign films – both U.S. and non – may be imported into China annually,[15] and importation can only be conducted by film import enterprises designated or approved by the SARFT.[16] Currently, there is only one entity approved to import films: the China Film Import and Export Corporation, a wholly state-owned entity.[17]

Following importation of their films, U.S. studios must secure a distributor. In its submissions to the WTO, the U.S. made the following allegations about the system of distributing films for theatrical release in China: distribution can only occur through one of two Chinese state-controlled distributors;[18] both members of the distribution duopoly[19] use identical form contracts and do not permit negotiation of key terms;[20] China Film Group actually decides on the distributor and distribution conditions for all imported films;[21] this distribution regime facing U.S. films contrasts starkly with the open distribution system available for domestic films, as Chinese films may be distributed by their production studios, or a full range of film distributors in China, with terms being negotiated commercially and competitively.[22] Thus, China maintains a high barrier for the importation and distribution of foreign films. It intends this barrier to facilitate trade protectionism and function as a cultural filtration device, limiting the number of foreign films to which Chinese citizens are exposed.

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[14] *See China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products,supra* note 7, at 84.

[15] Lee, *supra* note 8, at 389.

[16] *See China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products,supra* note 7, at 85.

[17] *Id.* at ¶ 7.575.

[18] *Id.* at ¶ 7.1660.

[19] Although the WTO Panel rejected the U.S. argument that China's *rules*created the duopoly (either de jure or de facto), a duopoly exists in fact nonetheless. For a detailed discussion of the duopoly argument, see *id.* at 451-58.

[20] *Id.* at ¶ 4.24.

[21] *Id.* at ¶ 4.30.

[22] *Id.* at ¶ 4.24, ¶ 4.30. Regarding these obstacles to distribution I have purposefully referred to the U.S. arguments, rather than the Panel Report, simply because the Panel rejected the claim of a de facto distribution duopoly. However, that rejection was founded merely upon a deficiency of evidence submitted, and does not alter the pragmatic obstacles faced by U.S. films studios seeking to release their films in Chinese cinemas.

(b) Censorship

Censorship in China is extensive and disquieting.[23] The current Internet crisis serves as a cautionary tale for both free speech advocates and expansionist capitalists.[24] For the U.S. film industry, the ominous specter of Chinese censorship is just as perturbing and no less commercially disruptive.[25] All films imported into China must pass the strict scrutiny of censors,[26] but because the country lacks a film rating system and censors can interpret the censorship guidelines in a number of different ways, the process is very unpredictable.[27] This creates problems for U.S. studios that would like to pre-censor their films to avoid delays.[28] A lamentable dilemma faces U.S. film executives in this regard. To ensure a quicker grant of censorship approval, the studios could adopt an overly cautious approach and remove all potentially condemnable material. This approach, however, may unnecessarily reduce the artistic quality and commercial appeal of the picture if, in reality, censors would not have objected to the removed content. On the other hand, the studios could take a less cautious approach and remove only that material that the censors are most likely to flag. The risk associated with this strategy is that censors may object to content "left in," causing censorship delays and resulting in significant commercial harm to the film.[29]

China's rigorous system of censorship unquestionably highlights the government's commitment to control the flow of cultural inputs in the market. Essentially, a censorship wall has been created to act as a second barrier to the entry of foreign films. However, a key difference between censorship and the

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[23] "Virtually all print and broadcast media are government-run or supervised, and subject to censorship by Communist Party propaganda officials." *China and the WTO: Let Me Entertain You*, Economist, Aug. 15, 2009, at 7.

[24] *See Google Ponders Leaving China: Failed Search,* Economist, Mar. 20, 2010, at 79. Chinese authorities have also been actively shutting down websites, and blocking the registration of new domain names. *See* Fredrik Erixon and Hosuk Lee-Makiyama, *Chinese Censorship Equals Chinese Protectionism,* Wall St. J., Jan. 6, 2010, *available at* http://online.wsj.com/article/SB10001424052748704842604574641620942668590.html.

[25] *See* Vivien Cui, *Mainland release of Mission Impossible Possible,*South China Morning Post, May 16, 2006, at 1.

[26] Gerardo Lara, *The Piracy of American Films in China: Why the U.S. Art Form is Not Protected by Copyright Laws in the People's Republic of China*, 2 UCLA J. Int'l L. & Foreign Aff. 343, 356 (1997-98).

[27] *See* Miller, *supra* note 9, at 37.

[28] *Id.*

[29] The relationship between piracy and censorship delays will be examined in greater detail below.

import quota is that both the U.S. film industry and the Chinese film industry must overcome the censorship barrier.

(c) Blackout Periods

Periodically, China institutes cultural "blackout" periods, during which foreign films cannot be shown in theaters.[30] Asian media reports that imported films are subject to removal at any time the government decides to hold an "impromptu film festival."[31] Although this indicates a lack of predictability, reports suggest that there is one annual period during which foreign films are "routinely barred from screening."[32] This period occurs during July, coinciding with the school summer holidays. Naturally, this inflicts significant losses on summer blockbusters.[33]

It would be naïve to disregard the protectionist nature of blackout periods, considering the boost given to domestic films at the expense of American films. They are certainly designed to "make room for domestic Chinese films during peak summer viewing days."[34] However, they are not confined to summer and may occur numerous times during the year, spontaneously and suddenly.[35] For this reason it has been suggested that the Chinese authorities pull films that do "too well" at the box office.[36]

In addition to economic concerns, blackout dates are heavily focused – ostensibly, at least – on cultural management. The Chinese government is attempting to fence out the Hollywood influence at key times of the year – most notably, at those times when the malleability of youth is exposed and vulnerable.

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[30] *See* Lee, *supra* note 8, at 389.

[31] Aventurina King, *Curtains For Foreign Cinemas?*, Asia Times Online, Dec. 2, 2006, *available at* http://www.atimes.com/atimes/China_Business/HL02Cb02.html.

[32] Cui, *supra* note 25.

[33] For example, China refused to screen *Spider-Man 2*, *Harry Potter and the Prisoner of Azkaban*, and *Shrek 2* in July 2004 due to a blackout period carrying the supposed aim of encouraging "more upright pursuits" among the nation's youth. *See* Carl Erik Heiberg, *American Films in China: An Analysis of China's Intellectual Property Record and Reconsideration of Cultural Trade Exceptions Amidst Rampant Piracy*, 15 Minn. J. Int'l L. 219, 237 (2006).

[34] Miller, *supra* note 9, at 37.

[35] King, *supra* note 31.

[36] Miller, *supra* note 9, at 37. One U.S. film with respect to which this allegation has been levied is *The Da Vinci Code*, which was scheduled for a three-week run but was pulled after it made more than $13 million dollars in China.

III. INSUFFICIENT IP ENFORCEMENT AND THE DISSEMINATION OF WESTERN CULTURE WITHIN CHINA

Piracy is pervasive throughout China.[37] IP enforcement is so deficient that some U.S. studios see only two options for commercial viability: compete with pirates on price, or convert pirates to legitimate retailers.[38] However, underlying the pervasiveness of piracy is a relatively straightforward market dynamic: because lawful supply cannot meet demand, unlawful supply takes its place.[39] The Motion Picture Association of America enunciates fiercely that the current import quota of twenty films per year falls far short of market demand for "primarily American films."[40] Many commentators argue that when consumers are unable to purchase products in the open market, they "may settle for black market products or pirated goods."[41] Thus, in the "large and hungry"[42] Chinese market, consumers who wish to see certain movies that are unavailable through legitimate channels have little choice but to purchase unlicensed copies.[43] Those unlicensed copies are facilitated by the lack of robust IP enforcement. We can assume that the import quota serves two goals: limiting the influx of Western culture presented in U.S. films, and protecting the domestic film industry.[44] Aside from the economic objective associated with the latter goal, both goals share the same underlying cultural

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[37] It is reported that 90% of all DVDs sold in China are pirated. *See*Michael C. Ellis, Report, *The Cost of Motion Picture Piracy – To China, Asia and the World, available at* http://www.mpaa.org/press_releases/leksummarympa.pdf (last visited Nov. 8, 2010). In 2005, the US film industry lost an estimated $2.1 billion to piracy in China. *See* Jordana Cornish, *Cracks in the Great Wall: Why China's Copyright Law Has Failed to Prevent Piracy of American Movies Within Its Borders,* 9 Vand. J. Ent. & Tech. L. 405, 411 (2006). It is worth noting that the value of lost revenue to piracy varies according to method of calculation and figures differ. *See generally* Aaron Schwabach, *Intellectual Property Piracy: Perception and Reality in China, The United States and Elsewhere,* 2 J. Int'l Media & Ent. L. 65 (2008).

[38] CAV Warner Home Video has started to treat pirates as competitors by lowering prices and shortening the window between theatrical release and DVD release. It also attempts "to convert stores that sell counterfeit goods into sellers of licensed DVDs." Miller, *supra* note 9, at 38.

[39] *See* Lara, *supra* note 26, at 355.

[40] Heiberg, *supra* note 33, at 236 (citing testimony of Fritz E. Attaway, Executive Vice President and Wash. General Counsel, MPAA).

[41] Peter K. Yu, *Piracy, Prejudice and Perspectives: An Attempt to Use Shakespeare to Reconfigure the US-China Intellectual Property Debate,* 19 B.U. Int'l L. J. 1, 31 (2001). *See also* Derek Dessler, *China's Intellectual Property Protection: Prospects for Achieving International Standards,* 19 Fordham Int'l L. J. 181, 232 (1995) ("Commentators argue that these market access barriers facilitate intellectual property piracy").

[42] Heiberg, *supra* note 33, at 236.

[43] Schwabach, *supra* note 37, at 75 n.49.

[44] Carl Erik Heiberg makes a similar suggestion, *supra* note 33, at 256.

objective: preserve and promote Chinese culture at the expense of Western culture. Yet the import quota, without adequate IP enforcement, is producing a result that is directly perverse to this purpose.

Uncensored, pirated copies of U.S. films are widely available on the streets of China at a price far lower than the admission to a movie theater.[45] This is without question a widespread dissemination of Western culture, fostered by a lack of commitment on the part of the Chinese government to eradicate piracy. If the Chinese government increased the number of foreign films imported into China, it would satisfy some of the market demand for U.S. films and reduce some of the demand for pirated films, thereby limiting the dissemination of Western culture and helping China achieve its cultural objectives.

Analyzing the intersection between piracy and inadequate lawful supply necessarily encompasses more than a mere discussion of the import quota. Censorship also plays three fundamental roles in fostering piracy. Firstly, Chinese censorship authorities are often slow in approving U.S. films, and this can give pirates a significant head start on reaching the market.[46] Secondly, Chinese legislation denies copyright protection to films that have not yet been approved by censors.[47] Thus, while a film is awaiting approval, pirates can operate without fear of legal sanction. Finally, the content of pirated films has typically not been subjected to censorship.[48] Therefore, pirates are actually in a position to offer a product, which may be more desirable to consumers than a legitimate copy.

The cultural blackout periods referred to earlier also act as an acute constraint on lawful supply, creating a void for pirates to fill. During these periods, pirates operate without competition, which inflicts a particularly severe commercial detriment to U.S. film studios, especially in light of their tendency to

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[45] "The latest Hollywood movies are on DVDs on street corners across China within days of their release, at a cost of $1 or less." Keith Bradsher,*WTO Rules Against China's Limits on Imports*, N.Y. Times, Aug. 12, 2009, at A1.

[46] *Mission Impossible III* serves as a suitable illustration of this point. The film was originally scheduled for a simultaneous release in the U.S. and China. However, because censors opined that the film depicted Shanghai as "run down" and the police force as "clumsy," the release was, at the time, "indefinitely postponed." Upon learning of the censorship controversy, interested moviegoers allegedly turned to illegitimate copies, which were already available on the market, rather than wait for the official outcome. Cui,*supra* note 25. *See also* Miller, *supra* note 9, at 37.

[47] Morrison, *supra* note 2, at 18.

[48] Miller, *supra* note 9, at 37.

release summer blockbusters simultaneously across the globe.[49] Thus, rampant piracy of U.S. films in China clearly nullifies the government's cultural input barriers. The import quota, censorship and blackout dates actually provoke an injection of U.S. culture into the market.

IV. REFORM PROPOSAL

In light of the foregoing, China should implement the following reforms in order to achieve its cultural objectives. A consequential benefit will accrue insofar as these reforms may help remedy some of the complaints raised by the U.S. at the WTO.[50] Although the reforms outlined below may not offer a complete formalistic resolve to China's WTO obligations, the reforms will benefit U.S. filmmakers, and this should help mitigate the current adversarial guise of U.S.-Sino relations.

(a) Strengthen IP Enforcement

By eradicating piracy to the greatest extent possible, China will limit the dissemination of uncensored U.S. films and thereby further its cultural objectives.

Furthermore, China's own film industry will benefit from increased revenues, and this is especially important for domestic films, which have enjoyed extensive government promotion.[51] Typically, piracy diverts these government funds away from the official channel of revenue receipt. Without piracy, however, the funds would remain in official channels and could thus be used to strengthen the domestic film industry in a manner consistent with the government's desired cultural trajectory.

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[49] Exploitation of such releases in China is extremely difficult because potential audiences may have had access to the pirated copy months prior to the film actually being released in theaters.

[50] I refer to the complaints made by the U.S. against China in Appellate Body Report, *China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, WT/DS363/AB/R (Dec. 21, 2009).

[51] Examples of movies, heavily supported by the Chinese government include *The Founding of a Republic* and *Confucius*. The latter is a biopic of the ancient philosopher while the former celebrates 60 years of the People's Republic of China and features 120 top Chinese actors. For further information on these movies, including how they were received by audiences,*see* Sharon LaFraniere, *China's Zeal for Avatar Crowds Out Confucius,* N.Y. Times, Jan. 30, 2010, at A4 and Steven Schwankert, *China Reiterates Screen Limits for Foreign Films*, Film Journal International, Jan. 27, 2010, *available at* http://www.filmjournal.com/filmjournal/content_display/esearch/e3if8d7feafe64b6fb76023a4453148d396.

(b) Increase the Import Quota

Increasing lawful supply is a necessary corollary to eradicating piracy. It is essential that China reduce incentives to pirate by the greatest degree possible. If consumers have greater lawful access to U.S. films, they may be dissuaded from purchasing pirated DVDs of the same films. If, simultaneously, punishment for piracy is real and exorbitant, the risk-reward ratio of piracy may become so high as to act as a substantial deterrent.

In addition to helping reduce piracy, increasing the import quota may lead to increased domestic cinema construction, which itself may benefit the domestic film industry.[52] Naturally, China should strive for a balance between the number of films imported, piracy reduction, and benefits to the domestic industry. After all, flooding the market with U.S. films would not achieve its cultural objectives. However, increasing the number of imports would. The benefit of legitimate importation over piracy is that China retains censorship control.

(c) Reduce Censorship Delays

As I have already discussed, delays in censorship approval can give pirates a significant lead-time to reach the market. Thus, in conjunction with an increased import quota, China should invest in its censorship infrastructure in two ways: firstly, it must increase efficiency by decreasing the processing time for approval of imported films; secondly, it must increase transparency so that U.S. film companies can pre-censor their material. Releasing a film on the same date globally is an effective means of limiting piracy. It is therefore vital to China's interests that its censors are not the weak link in an otherwise industrious chain of effort that makes the simultaneous release possible.

Censorship will be the most fundamental valve for China to control cultural direction, and it is also the least destructive to the commercial interests of U.S. filmmakers. However, China should strive to keep the level of censorship within the bounds of consumer acceptability. Otherwise, pirates may be inspired to capitalize on consumer demand for uncensored versions of the films.

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[52] Although certainly a biased commentator, James Cameron's recent remarks in Beijing seem logical: "opening the doors in China . . . will raise the entire film industry [and] raise the "Chinese filmmakers' ability to play their films." Gillian Wong, *James Cameron: China Should Let More Movies In*, ABC News Online Dec. 23, 2009, *available at* http://abcnews.go.com/Entertainment/wireStory?id=9407012.

(d) Relax Restrictions on the Domestic Film Industry

Ultimately, as China's middle class grows, entertainment will only increase in importance. The demand for foreign films is currently fuelled, in part, by the perceived superiority of U.S. filmmakers and their ability to entertain an audience.[53] Although the Chinese film industry has made great advances, government authorities must allow Chinese artists greater freedom[54] to promote greater competition between domestic artists and the cultural influences of imported entertainment.

Similar to import quotas, Chinese authorities must strive to achieve the optimum balance between fostering a competitive domestic industry and not sacrificing their fundamental cultural objectives. In other words, the government need not lift all restrictions currently placed on Chinese filmmakers. Instead, it must only relax restrictions to the point that the cultural benefits of a truly competitive domestic industry outweigh the perceived negative cultural effects of forfeiting a degree of control over the industry.

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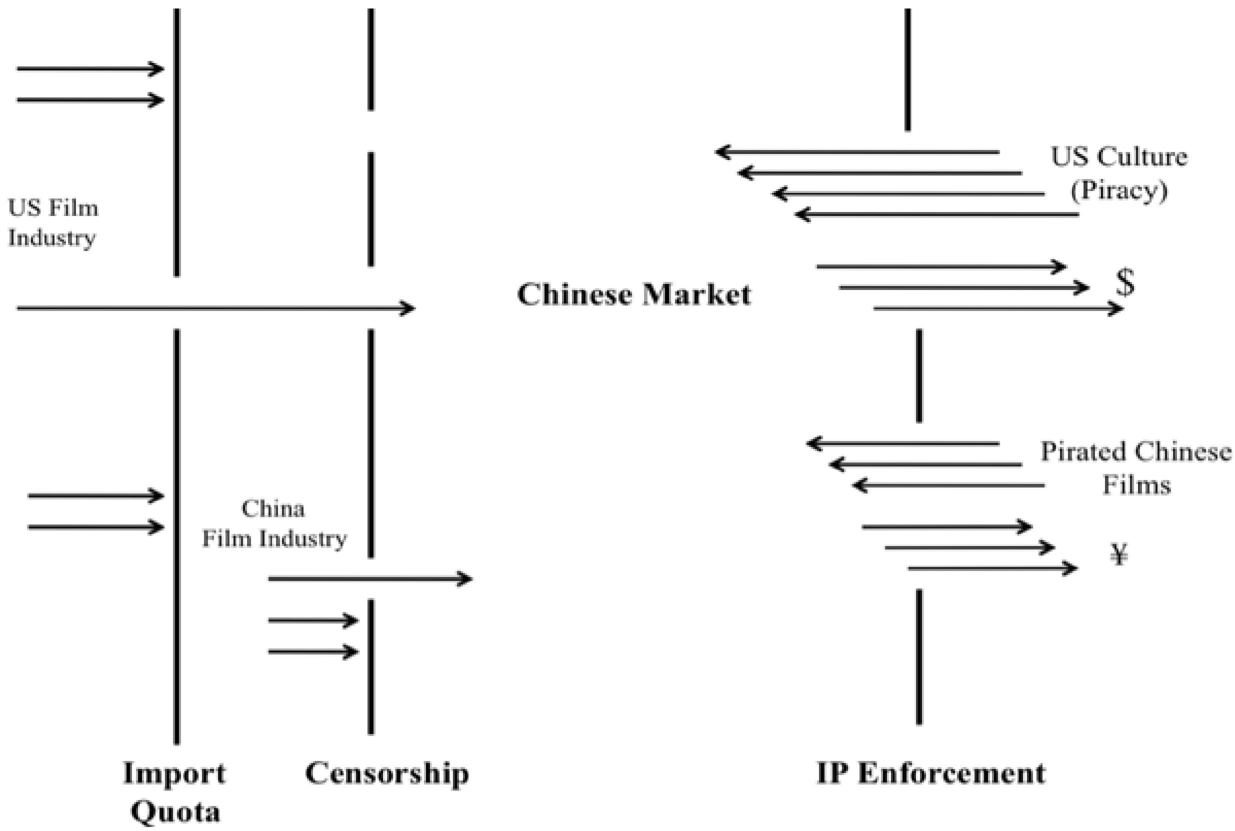
[53] *See* Juliet Ye, *China's Avatar Restrictions Cause a Stir*, Wall St. J., Jan. 20, 2010, *available at* http://blogs.wsj.com/chinarealtime/2010/01/20/china%E2%80%99s-avatar-restrictions-cause-a-stir/.

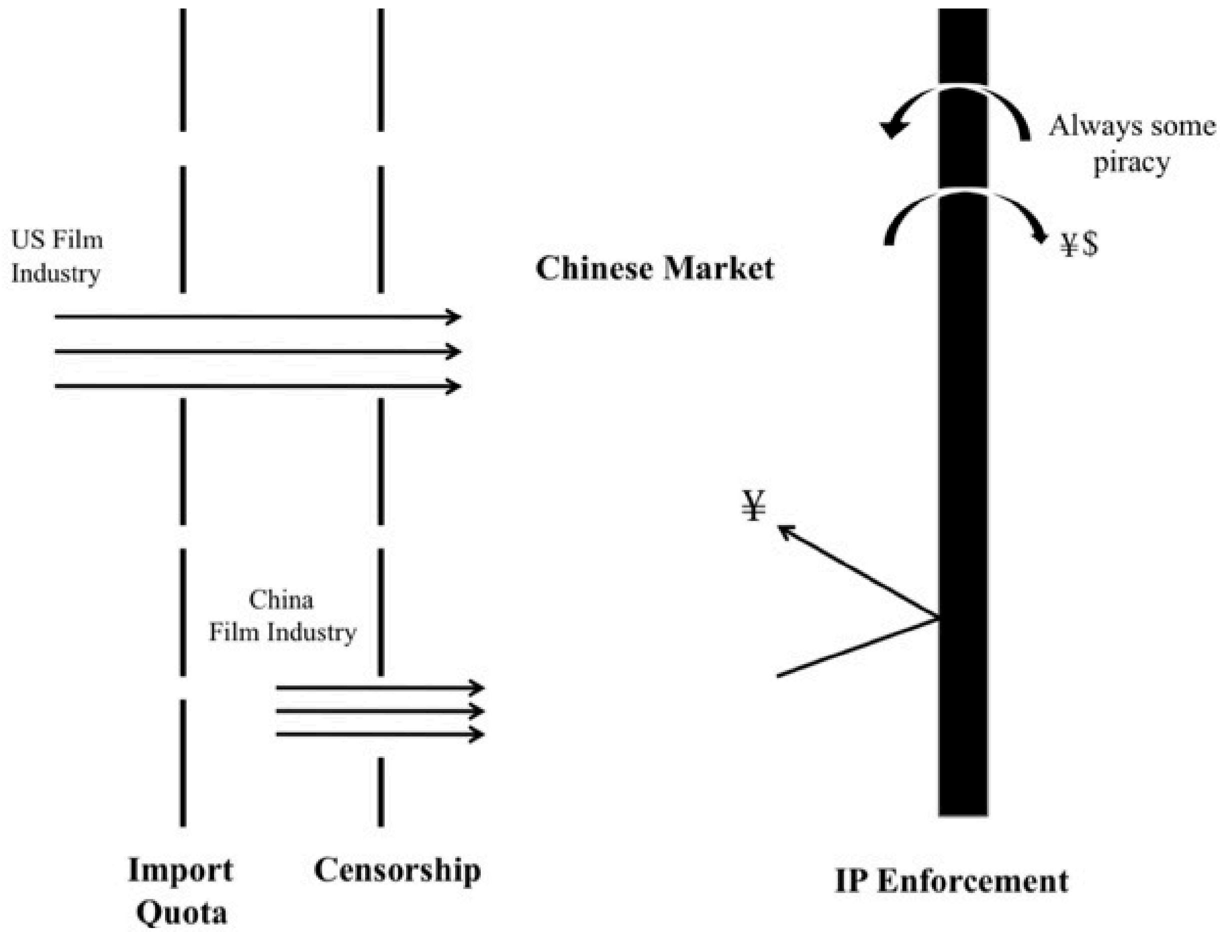
[54] In China, artistic freedom in domestic film production is severely restrained and this impacts upon the ability of domestic film producers to compete vigorously with Hollywood movies. *See* Louisa Lim, *Film Director Battles for Soul of Chinese Cinema*, NPR.org, Jan. 4, 2010, *available at* http://www.npr.org/templates/story/story.php?storyId=121570362&ft=1&f=1004.

V. CURRENT MARKET STRUCTURE



On the left side of the chart above, I have depicted China's barriers intended to control cultural inputs. The U.S. film industry must overcome two barriers to entry: the import quota and censorship. Only some U.S. films pass through both barriers and reach the Chinese market. Naturally, China's own film industry must not overcome the import quota; however, it must still contend with censorship. Although China seems concerned with filtering cultural inputs on the left side of the chart, the right side of the chart shows the glaring deficiency due to insufficient IP enforcement. Piracy allows vast quantities of uncensored U.S. culture into the market, while extracting significant revenue owed to the U.S. industry (leading to political and legal tensions). Piracy of Chinese films extracts revenue from the market that would otherwise strengthen the Chinese film industry.

VI. PROPOSED MARKET STRUCTURE



The chart above represents the proposed market structure. Allowing more U.S. films to legitimately enter the market would increase U.S. cultural input; however, China could still rely on the censorship barrier as a cultural valve. Relaxing censorship constraints on the Chinese film industry would strengthen the industry and increase its cultural input. On the right side of the chart is a representation of increased IP enforcement. China benefits in two ways: first, there is a reduction in uncensored U.S. films entering the market, and therefore a reduction in uncontrolled cultural input; second, revenue owed to the Chinese film industry stays within official channels, which strengthens the domestic industry.

VII. CONCLUSION

The U.S.-China acrimony, engendered by China's current state-of-play for intellectual property holders, has attracted a saturating volume of legal scholarship.

Understandably, the majority of this commentary[55] champions Western pressure on China, via the WTO and other channels. Clearly, this approach has proved extremely fruitful recently, in light of U.S. success at the WTO. Without question, these rulings provide a platform to reform the status quo in China.

However, I propose that the U.S. should seek to supplement the WTO rulings with Chinese-orientated incentives that simultaneously benefit U.S. interests.[56] In order for China to achieve its cultural objectives, it must reform its current regime. One might contend that this argument, taken to the extreme, would simply result in China banning the import of all foreign films, while simultaneously cracking down on piracy. Yet this would not be in China's best interests. Due to its regulatory control of the revenue sharing mechanism, China stands to profit greatly from the legitimate exhibition of foreign films. Also, it is arguable that China's economic success heavily depends on at least a modicum of contentment among the middle class workforce. Given the high demand for U.S. films from this constituency, a total ban on foreign imports may be a treacherous move for the government.

My proposals reflect an endorsement of cultural regulation; if implemented, the new market structure would inevitably restrict the dissemination of information throughout China. In light of this, the U.S. film industry may be hesitant to pursue the type of argument presented in this paper, for fear of allegations of cynicism. Nonetheless, I believe my position can be defended on two fundamental grounds.

The first ground concerns the issue of sovereignty. Put simply, China has a right to define the contours of its culture. As recognized by the WTO, "the protection of public morals is a highly important governmental interest."[57] Therefore, in seeking to resolve their grievances, U.S. IP holders cannot, and should not, interfere with China's cultural progression, other than to monetize their creative output and vigorously enforce their property rights. U.S. filmmakers need not be expected to sustain altruistically the plight of piracy in order to maintain a cultural interchange, which is contrary to the policy of a sovereign nation.

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[55] In U.S. law journals.

[56] A similar power struggle is occurring between the U.S. and China over allegations that China is not allowing the yuan to appreciate in value. Similar to the film debate, the power of external influence vs. internal incentive has arisen. It has been suggested that "foreign cajoling may not do the trick. But inflation might." *Chinese Foreign Policy: Not Pointing or Wagging, But Beckoning*, Economist, Mar. 20, 2010, at 5.

[57] *China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, *supra* note 7, at ¶ 7.868.

The second ground of defense centers directly on property rights. Respect for the ownership of private property is a bedrock principle of U.S. policy. Meanwhile, the current regime in China evidences disregard for the property rights of U.S. copyright holders. It may be true that a beneficial side effect of this market structure is that Chinese citizens enjoy greater exposure to unfiltered expression. However, this exposure comes at great cost. The foundations of this cultural influence rest on piracy, an enterprise that flies in the face of private property rights. In persuading the Chinese authorities to exercise greater control of cultural influence, the U.S. film industry would be indirectly raising the status of private property ownership throughout China. From a U.S. perspective, the idea of private property ownership is arguably a cultural export of at least equal significance to free speech. Therefore, I believe that it is thoroughly appropriate to advance the market reforms proposed herein, as the result will accord with U.S. policy.

In summation, the adage of "change must come from within" is robust and time honored for a reason. If Chinese authorities are not ready to embrace the trappings of Western culture, then so be it. The pursuit of free expression does not necessarily correlate to the interests of intellectual property holders.[58] Nonetheless this should not deter filmmakers from pursuing legitimate revenue that stands to be extracted from the market. The U.S. film industry can increase its profits in China without demanding that Chinese authorities cease their control of cultural development. Each objective can co-exist and the reforms mentioned above should help satisfy both parties. All that remains now is to convince China.

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[58] Jing Zhang argues that because China has no freedom of speech, "a hasty drive for copyright enforcement may pose a threat to the already terribly meager freedom Chinese people enjoy." Jing Zhang, *Pushing Copyright Law in China: A Double Edged Sword,* 18 DePaul-LCA J. Art & Ent. L. 27, 76 (1997).

STUDENT SPEECH IN ONLINE SOCIAL NETWORKING SITES: WHERE TO DRAW THE LINE

MICHAEL J. KASDAN*

Do Facebook, Twitter, and MySpace require courts to Tinker *with the Supreme Court's student speech trilogy of* Tinker *to* Bethel *to* Morse*? Michael J. Kasdan examines the struggle to define the proper place of so-called "student internet speech."*

INTRODUCTION

The move toward online communication has the potential to throw off the historically careful balance that has been struck regarding First Amendment issues in the realm of "student speech." In a seminal trilogy of cases, the Supreme Court balanced the free speech rights of students with school districts' ability – and even responsibility – to regulate student speech that disrupts the learning environment. Before the proliferation of instant messaging, SMS texts, and social networking sites, the Court allowed schools to regulate on-campus speech in limited circumstances (i.e., when the speech disrupts the learning environment) but did not extend the school's authority to regulate speech that occurs off-campus (i.e., speech subject to traditional First Amendment protection). Electronic communication blurs the boundary between on- and off-campus speech. While a student may post a Facebook message from the seeming privacy of his or her own home, that message is widely accessible and could have a potentially disruptive effect on campus.

Because the Supreme Court has not yet addressed this particular issue, courts are struggling to define the proper place of so-called "student internet speech." Indeed, two different Third Circuit panels recently came to exactly opposite conclusions on the very same day about the ability of schools to regulate student internet speech: in one, the Third Circuit upheld a school's ability to discipline a student for creating a fake MySpace profile mocking the school's principal; in the other, the Third Circuit held the school could not regulate conduct (again, creation of a fake MySpace profile about the school's principal) that occurred within the student's home. Both opinions have since been vacated

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pending a consolidated rehearing *en banc*, but the message is clear: courts throughout the country require guidance on the appropriate legal principles applicable to student internet speech.

The remainder of this Article introduces the relevant Supreme Court precedent, explores in greater depth the two contradictory Third Circuit opinions, and offers some preliminary analysis as to how the Third Circuit (and perhaps ultimately the Supreme Court) may clarify the law in the pending *en banc* decision.

BACKGROUND – SUPREME COURT PRECEDENT

The Supreme Court's seminal pronouncement that set the limits of a school's ability to regulate student speech came down in 1969. In *Tinker v. Des Moines Independent Community School District*, the Supreme Court addressed the issue of "First Amendment rights, applied in light of the special characteristics of the school environment."[1] The Court reasoned that while students do not "shed their constitutional rights to freedom of speech or expression at the schoolhouse gate," the right to free speech must be balanced against the interest in allowing "[s]tates and of school officials, consistent with fundamental constitutional safeguards, to prescribe and control conduct in the schools."[2] The so-called *Tinker* rule holds that in order for a school district to suppress student speech (by issuing a punishment or discipline relating to that speech), the speech must materially disrupt the school, involve substantial disorder, or invade the rights of others: "conduct by the student, in class or out of it, which for any reason — whether it stems from time, place, or type of behavior — materially disrupts class work or involves substantial disorder or invasion of the rights of others is, of course, not immunized by the constitutional guarantee of freedom of speech."[3]

Since *Tinker*, the Supreme Court has addressed free speech issues in the context of schools in several cases. In each case, the Court addressed the tension between the students' right to free expression and the schools' need to regulate school conduct in favor of the schools. In *Bethel School District v. Fraser*,[4] the

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[1] 393 U.S. 503, 506 (1969). *Tinker* involved an in-school passive display of political "speech," students wearing black armbands in school to protest the Vietnam War. The Court found that while there is a need to provide for authority to regulate disruptive speech in schools, in this case the speech was silent and passive, and there was no "evidence that the authorities had reason to anticipate that the wearing of the armbands would substantially interfere with the work of the school or impinge upon the rights of other students." *Id.* at 509. Accordingly, the discipline was found to be a violation of the First Amendment. *Id.* at 510-11.

[2] *Id.* at 506-07.

[3] *Id.* at 513.

[4] 478 U.S. 675 (1986).

Court distinguished *Tinker* and found that a school's discipline of a student for his sexual-innuendo-charged assembly speech was not a violation of the student's First Amendment rights.[5] More recently, in *Morse v. Frederick*, the Court held that the First Amendment does not prevent school officials from suppressing student speech that was reasonably viewed as promoting illegal drug use at a school-supervised event.[6]

TODAY'S ONLINE STUDENT SPEECH CASES

The degree to which student online speech may be regulated is an increasingly significant issue. As stated in a recent New York Times article, "the Internet is where children are growing up. The average young person spends seven and a half hours a day with a computer, television, or smart phone . . . suggesting

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[5] *Bethel*, unlike *Tinker*, did not involve political speech, nor was it of the silent variety. In *Bethel*, a student delivered a speech at a school event that was based wholly on "explicit sexual metaphor." *Id.* at 676. The speech, supporting the candidacy of the speaker's friend for student counsel, used repeated sexual innuendo to comic effect. In finding that the First Amendment did not prevent the school from disciplining the student for the speech, the Court remarked that it was "perfectly appropriate for the school to . . . make the point to pupils that vulgar speech and lewd conduct is wholly inconsistent with the 'fundamental values' of public school education." *Id.* at 685-86. The in-school nature of the speech was central to this case. Indeed, Justice Brennan was careful to note in his concurrence that the holding should be narrowly limited to in-school circumstances. Brennan argued that under applicable Supreme Court precedent, if the same speech had been given "outside of the school environment, he could not be penalized simply because government officials considered his language to be inappropriate" because the speech was far removed from the category of "obscene" speech that is unprotected by the First Amendment. *Id.* at 688. Moreover, the discipline was not based on the fact that the school district disagreed with the political viewpoint of the speech; rather, the basis for the discipline was the school's interest in ensuring that a school event proceeded in an orderly manner. Accordingly, Justice Brennan cast the Court's holding narrowly: "the Court's holding concerns only the authority that school officials have to restrict a high school student's use of disruptive language in a speech given at a high school assembly." *Id.* at 689**.**

[6] Morse v. Frederick, 551 U.S. 393 (2007). In *Morse*, the Court found that a school district may discipline a student for speech at a school event that was regarded as encouraging illegal drug use without running afoul of the First Amendment. *Id.* at 408. There, a student was suspended from school after refusing to take down a banner stating "BONG HiTS 4 JESUS" that he unfurled at a school event. *Id.* at 393. Under these circumstances, the Court found that even though there was no "substantial disruption" caused, *id.*, the discipline by the school was nevertheless appropriate in view of "the special characteristics of the school environment," *id.* (quoting *Tinker*), because schools are entitled to take steps to safeguard the students entrusted into their care from speech that could be reasonably regarded as encouraging illegal drug use.

that almost every extra curricular hour is devoted to online life."[7] And today's online speech has some distinguishing characteristics from "ordinary speech." It is extremely public. It may be rapidly distributed to a wide group of people extremely quickly. And it may potentially be saved forever.

A recent series of cases demonstrate that courts are grappling with how to apply the Supreme Court free-speech precedent to student speech that has moved to online mediums such as the now-ubiquitous Facebook or Twitter. None of the triumvirate of Supreme Court student speech cases maps easily to the arena of online student speech. As one state supreme court noted,

> "[u]nfortunately, the United States Supreme Court has not revisited this area [of the First Amendment rights of public school students] for fifteen years. Thus, the breadth and contour of these cases and their application to differing circumstances continues to evolve. Moreover, the advent of the Internet has complicated analysis of restrictions on speech. Indeed, *Tinker*'s simple armband, worn silently and brought into a Des Moines, Iowa classroom, has been replaced by [today's student's] complex multi-media website, accessible to fellow students, teachers, and the world."[8]

A recent series of cases from the Third Circuit demonstrates the complexities raised by these cases. In one case, a Third Circuit panel found a school's discipline of a student for his online speech to be a violation of the First Amendment and that the school's authority could not extend to such off-campus behavior. That very same day, a different Third Circuit panel addressing an almost identical fact pattern came to the opposite conclusion, finding no First Amendment violation when a school district punished a student for online speech.

RECENT ONLINE STUDENT SPEECH CASES

J.S. ex rel. Snyder v. Blue Mountain School District

In *J.S.*, the Third Circuit affirmed a district court ruling that a school district had acted within its authority in disciplining a student for creating an online profile on her MySpace page that alluded to "sexually inappropriate behavior and illegal conduct" by her principal.[9]

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[7] Stephanie Clifford, *Teaching About Web Includes Troublesome Parts*, N.Y. Times, Apr. 8, 2010, at A15.

[8] *J.S. ex rel. H.S. v. Bethlehem Area School Dist.*, 807 A.2d 847, 863-64 (Pa. 2002).

[9] *J.S. ex rel. Snyder v. Blue Mountain Sch. Dist.*, 593 F.3d 286, 308 (3rd Cir. 2010).

The student was a 14-year-old eighth-grader who, along with a friend, had been disciplined by the principal for a dress code violation. A month later, the students created a fictitious profile for the principal from a home computer on MySpace. The MySpace profile, which included a picture of the principal taken from the school's website, described him as a pedophile and a sex addict whose interests included "being a tight ass," "[having sex] in my office," and "hitting on students and their parents." Word of the MySpace profile soon spread around school. Eventually, the principal found out about it. In response, the principal issued the students a ten-day suspension for violating the school's rule against making false accusations against members of the school staff.[10]

The students' parents sued the school district, claiming that the suspension was a violation of their children's First Amendment rights. The district court disagreed and found for the school board, concluding that the school had acted properly in suspending the students and that their First Amendment rights had not been violated.[11]

On appeal, the Third Circuit affirmed. The Panel majority noted that although the Supreme Court "has not yet spoken on the relatively new area of student internet speech," courts can derive the relevant legal principles from traditional student speech cases, such as *Tinker*, *Bethel*, and *Morse*.[12] Drawing from the *Tinker* standard that a school may discipline students for speech that "create[s] a significant threat of substantial disruption" within the school,[13] the Third Circuit found that discipline was appropriate and permissible based primarily on the fact that the profile targeted the principal in a manner that could have undermined his authority by referencing "activities clearly inappropriate for a Middle School principal and illegal for any adult."[14] The court also found that the online context of the speech, which allowed for quick and widespread distribution, exacerbated the situation and increased the likelihood of "substantial disruption."[15]

In a strongly written dissent, one of the panel Judges concluded that the *Tinker* standard had not been met: *Tinker* requires a showing of "specific and significant fear of disruption, not just some remote apprehension of disturbance."[16] While acknowledging the general power of school officials to

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[10] *Id.* at 291-93.
[11] *Id.* at 290-95.
[12] *Id.* at 295-97.
[13] *Id.* at 298.
[14] *Id.* at 300.
[15] *Id*.
[16] *Id.* at 312 (Chagares, J. concurring in part and dissenting in part).

regulate conduct at schools, the dissent concluded that the majority decision vests school officials with dangerously over-broad censorship authority in that it "adopt[s] a rule that allows school officials to punish any speech by a student that takes place anywhere, at any time, as long as it is about the school or a school official . . . and is deemed 'offensive' by the prevailing authority."[17] The dissent further noted that "[n]either the Supreme Court nor this Court has ever allowed schools to punish students for off-campus speech that is not school-sponsored and that caused no substantial disruption at school."[18]

Layshock v. Hermitage School District

Curiously, a different panel of Judges of the Third Circuit reached the opposite conclusion on the very same day in a similar case, *Layshock v. Hermitage School District*.[19] In *Layshock*, the Third Circuit panel affirmed a district court ruling that Hermitage School District's suspension of high school student Justin Layshock for his "parody profile" of the high school principal on his MySpace page was improper. The *Layshock* panel concluded that the high school's discipline of the student for his online behavior violated his First Amendment free speech rights and that the school's authority did not reach such off-campus behavior.[20]

The student, a 17-year-old high school senior, created a fake MySpace profile in the name of his principal, using a picture of the principal from the school's website. The profile mocked the principal, indicating that he was a "big steroid freak," a "big hard ass" and a "big whore" who smoked a "big blunt." When the principal learned of the profile, he issued a ten-day suspension and barred Justin from extracurricular activities for disruption of school activities, harassment of a school administrator over the Internet, and computer policy violations.[21]

Layshock's parents sued the school district and the principal, asserting violations of the First and Fourteenth Amendments. The district court ruled in their favor on the First Amendment claim, concluding that the school was unable to establish "a sufficient nexus between Justin's speech and a substantial disruption

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[17] *Id.* at 318.
[18] *Id.* at 308.
[19] 593 F.3d 249 (3rd Cir. 2010).
[20] *Id.* at 252-54.
[21] *Id*.

of the school environment, which is necessary to suppress students' speech per *Tinker*."[22]

On appeal, the Third Circuit agreed that "it would be an unseemly and dangerous precedent to allow the state in the guise of school authorities to reach into a child's home and control his/her actions there to the same extent that they can control that child when he/she participates in school sponsored activities."[23] The court refused to allow the School District to exercise authority over a student "while he is sitting in his grandmother's home after school."[24]

On April 9, 2010, shortly after issuing the seemingly contradictory rulings in *J.S.* and *Layshock*, the Third Circuit agreed to rehear the two cases *en banc*. Given the factually similar circumstances of the two cases and their opposite results, it is not surprising that the Third Circuit found it necessary to provide clear guidance delineating what type of speech may be punished and how far school districts may go in punishing online speech. Argument was heard by the full court on June 3, 2010, and a ruling is expected sometime this year. The Third Circuit *en banc* review of the *J.S.* and *Layshock* cases may also be a precursor to a Supreme Court pronouncement on the topic of School regulation of online student speech.

CLARIFYING THE LAW?

One key issue raised in these *en banc* appeals – and in other cases around the country addressing similar issues[25] – is whether online speech by a student that is generated off school property and not during school hours, but is nonetheless directed at the school, can be regulated by a school district at all. That is, is such speech "student speech" that may be regulated under appropriate circumstances or is it "off-campus speech" that is out of the reach of school regulation under *Tinker*, *Bethel*, and *Morse*?

In the *en banc* appeals, the school districts argued in their briefing papers and at oral argument that the Supreme Court's reasoning in *Bethel* regarding the ability of schools to regulate disruptive student speech should likewise apply to online speech that is directed at school faculty. They argued that although such

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[22] *Id.* at 259-60.
[23] *Id.* at 260.
[24] *Id*.
[25] The Third Circuit cases discussed in depth in this article are merely illustrative of the differing results courts addressing this issue have reached. Similar cases have arisen across the country. *See, e.g.*, *Evans v. Bayer*, 684 F.Supp.2d 1365 (S.D. Fl. 2010) (holding, where student created fake and harassing Facebook profile of teacher, school districts may discipline off-campus speech only where such speech "raises on-campus concerns").

"speech" may be created outside of school, it is student speech, because it is specifically aimed at the school or a school administrator. Further, they argued that such speech may be restricted because it has a sufficient impact on the proper functioning of the school.[26] The districts reason that because students today create, send, and access communication using multiple methods including online social media sites, email, and text messaging, the proper focus is not where the speech was made, but whether its impact is felt in school.[27]

On the other hand, the students argued that a school district's ability to regulate disruptive student speech should not extend to speech outside of school and that the curtailment of students' off-campus speech is doctrinally indefensible.[28]

In my view, extending school districts' intentionally limited authority to off-campus speech — whether online or otherwise — would set a dangerous precedent. Indeed, during oral argument of the *en banc* appeals in June, Chief Judge McKee of the Third Circuit asked if a group of students could be punished if they were overheard in a baseball stadium calling their principal a "douchebag." The clear answer is no. Judge Rendell similarly noted that "the First Amendment allows people to say things that aren't nice."[29] These seem to be the right points to be making. In other words, how are the online profiles in the *J.S.* and *Layshock* cases any different than distasteful jokes or mocking speech about school officials made outside of school? The*Tinker-Bethel-Morse* trilogy of cases allows for limited regulation of speech in school; they simply do not contemplate otherwise limiting speech outside of school. While online speech undoubtedly has some characteristics that distinguish it from Judge McKee's example — i.e., a mocking online profile can be rapidly accessed by a wide group

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[26] *See J.S.*, 593 F.3d at 298 n.6 ("Electronic communication allows students to cause a substantial disruption to a school's learning environment even without being physically present. We decline to say that simply because the disruption to the learning environment originates from a computer off-campus, the school should be left powerless to discipline the student.").

[27] The District also noted that several other appellate courts have held that online speech created by a student at their home computer constitutes "student speech" for First Amendment purposes. *See, e.g.*, J.S. v. Bethlehem Area Sch. Dist., 807 A.2d 847 (Pa. 2002); Wisniewski v. Bd. of Educ. of Weedsport Cent. Sch. Dist., 494 F.3d 34 (2d Cir. 2007); Doninger v. Niehoff, 527 F.3d 41 (2d Cir. 2008). In each of those cases, the speech at issue was created at the students' home outside the physical presence of the schools they attended.

[28] *See J.S.*, 593 F.3d at 318 n.23 (explaining that Pennsylvania state law clearly intended *Bethel* to apply only to in-school speech).

[29] Shannon P. Duffy, *3rd Circuit Mulls Student Suspensions for MySpace Postings*, Law.Com, June 4, 2010, *available at* http://www.law.com/jsp/article.jsp?id=1202459201824.

of students and lasts longer than the spoken word — these differences do not justify redrawing the line in order to allow a school to regulate a student's out-of-school online speech.

A second key issue is, if schools were allowed to regulate such speech, how substantial must a disruption be to be considered a "substantial disruption" for which discipline is permitted? Is a school district's judgment that there is potential to cause disruption enough, or should more be required?

The school districts argue that they should have the authority to regulate speech when it is reasonably foreseeable that it would cause a substantial disruption in school.[30] But the students argue that if a school district is authorized to punish students' off-campus online speech based on a presumed "reasonable possibility" of future disruption, this would eviscerate the careful balance drawn in *Tinker*.

In my view, if schools are allowed to regulate online off-campus speech merely because it is directed towards school officials (a dubious proposition under Supreme Court First Amendment precedents), it is critical that this authority remain as limited as possible. One way to do that is to tie the school's authority to the presence of an in-school disruption. Giving schools the authority to determine that, in their view, there is a "reasonable potential" for a future disruption, even if there is no evidence of any disruption, seems to give them too much power. For instance, in the Third Circuit cases discussed above, it seems likely that anyone who viewed the fake MySpace profile would know it was intended as a joke. And there was no evidence of any disruption at all. Still, the school district punished the speech. This gives the school district too much power to discipline speech that occurs off-campus.

The principles set forth in the seminal Supreme Court student speech cases should favor the students in online speech cases – unless the courts adopt the view that online speech as inherently different from traditional speech. If so, then the rules regarding school regulation of student speech will change in turn. The Third

[30] "[B]oth the United States Supreme Court and this Court have held that a school district can act to restrict student speech based on a reasonable belief the speech would, in the foreseeable future, substantially disrupt or materially interfere with school activities. *See Tinker*, 393 U.S. at 514 ("the record does not demonstrate any facts which might *reasonably* have led school authorities to forecast substantial disruption of or material interference with school activities") (emphasis added); *Morse*, 551 U.S. at 403 ("*Tinker*held that student expression may not be suppressed unless school officials*reasonably* conclude that it will materially and substantially disrupt the work and discipline of the school") (emphasis added) (internal quotations omitted).

Circuit *en banc* cases and perhaps one day the Supreme Court – must now grapple with that issue.

HOW TO PROTECT AGAINST A LICENSING PARTNER'S BANKRUPTCY: PATENT LICENSES AND THE BANKRUPTCY CODE

BY JORDAN MARKHAM[*]

Since the financial crisis of 2008, many contractual partners who formerly looked rock solid have experienced major cash-flow problems. In addition, it has always been the case that in some fields of technology, such as biotech, a significant number of businesses are expected to fail. Thus, it is important to think through at the outset how a license might be treated by a bankruptcy court, and where possible, to structure the agreement accordingly. How to best do this will depend primarily on whether a party is the patentee or the licensee, and on the extent to which rights are transferred (i.e. whether the transaction results in a sale or merely a license agreement). As Jordan Markham *argues, in the context of a bankruptcy proceeding, the patentee is generally better served by a greater, and a licensee by a lesser, transfer of rights.*

I. INTRODUCTION

In uncertain times, or when dealing with uncertain partners, planning for the possibility of bankruptcy *ex ante* can provide a very real benefit to a party contemplating a patent licensing agreement. Since the financial crisis of 2008, many contractual partners who formerly looked rock solid have experienced major cash-flow problems. In addition, it has always been the case that in some fields of technology, such as biotech, a significant number of businesses are expected to fail. Thus, it is important to think through at the outset how a license might be treated by a bankruptcy court, and where possible, to structure the agreement accordingly. How to best do this will depend primarily on whether a party is the patentee or the licensee, and on the extent to which rights are transferred (i.e. whether the transaction results in a sale or merely a license agreement). As we shall see, in the context of a bankruptcy proceeding, the patentee is generally better served by a greater, and a licensee by a lesser, transfer of rights.

This article will explore these dynamics in detail. It will first consider the effects of a bankruptcy court's categorization of a patent rights transfer agreement

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as either an executory contract or a completed sale, and then it will consider how courts make this categorization. In particular, it will begin by describing the provisions in the Bankruptcy Code that deal with executory contracts and how the parties' rights depend on whether the debtor is the licensor or the licensee. It will then consider, from the view of patent law, the difference between assignments and licenses. It will move on to explore how courts in bankruptcy categorize assignments and different types of license agreements as either executory contracts or completed sales. Finally, it will conclude with practical suggestions that flow from the preceding analysis.

II. THE TREATMENT OF EXECUTORY CONTRACTS UNDER THE BANKRUPTCY CODE

A. Section 365(a) and the Power to Accept or Reject an Executory Contract

Under the bankruptcy code, a transfer of intellectual property rights is either a completed sale or an executory contract. But agreements respecting patent rights do not naturally present themselves as one or the other. Transactional intellectual property lawyers usually speak of transfers of patent rights in terms of assignments and licenses. For present purposes, the following simplifications are useful. An assignment is a transfer of all significant rights under a patent, including the right to sue. For bankruptcy purposes, an assignment is usually treated as a completed sale. A license is an agreement whereby a patentee agrees to refrain from enforcing her right to exclude the licensee from exploiting her invention in some way. The vast majority of effective license agreements are considered executory contracts for bankruptcy purposes.

Assignments result in fewer complications than licenses under bankruptcy law. If the bankrupt party is the buyer/assignee and the assignment does indeed amount to a completed sale, the rights under the assignment become property of the bankruptcy estate and may be disposed of accordingly.[1] Meanwhile, the seller/patentee need have no dealings with the bankruptcy proceeding except insofar as she is owed compensation by the bankrupt party (in which case her claims will be treated as any other prepetition claim of like kind).[2] Where the nondebtor is the buyer/assignee, unless the assignment amounts to a fraudulent

[1] *See* 11 U.S.C. § 541(a)(1) (2000) (defining the property of a bankruptcy estate as including "all legal or equitable interest of the debtor in property…").

[2] *See* 11 U.S.C. § 507 (2000) (establishing claim priorities).

transfer,[3] it is similarly free from entanglements with the bankruptcy proceeding since the bankrupt seller has already assigned over its rights.[4]

In contrast to the simplicity of completed sales, executory contracts are governed by the complex provisions of section 365 of the Bankruptcy Code[5] and are the subject of considerable controversy in bankruptcy courts. Section 365(a) permits "the trustee [or debtor in possession[6]], subject to the court's approval, [to] assume or reject any executory contract or unexpired lease of the debtor."[7] Note that section 365(a) pertains to executory contracts, as do the other subsections of section 365. These provisions, therefore, govern the vast majority of license agreements.[8] The effect of 365(a) is to allow the debtor[9] to assume or reject a contract depending on whether, from the debtor's perspective, the net gain outweighs the liabilities under the contract.

The power placed in the hands of the debtor by section 365(a) to accept or reject a contract without regard to the preferences of the opposite party is considerably limited by protections built into the remainder of the section or read into it by courts that serve that party's interests. Courts have held that the debtor must have some minimal business justification for its choice[10] and may not, for example, reject a contract for the sole purpose of harming a competitor.[11] Further, if the debtor chooses to assume a contract under 365(a), it must assume the entire

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[3] *See id.* § 548.

[4] Of course, if the buyer has not completed its obligations under conditions of the sale (for example, the buyer owes cash payments), these will remain owed to the estate.

[5] 11 U.S.C. § 365 (2000).

[6] *See id.* § 1107 (2000).

[7] *Id.* § 365.

[8] For the sake of readability this paper shall speak of licenses rather than patent rights transfers in the context of executory contracts. Similarly, it shall speak of licensees and licensors rather than transferees and transferors. This simplification is justified by the extreme rarity of patent rights transfers that are *not* licenses but *are* treated as executory contracts.

[9] A debtor in possession, as a general rule, has the same rights and duties as a trustee under the bankruptcy code. *See* 11 U.S.C. § 1107. For the purpose of readability, this paper shall use the term debtor rather than trustee or debtor in possession.

[10] *See* Johnson v. Fairco Corp. (*In re* Johnson), 61 B.R. 317, 320 (Bankr. N.D. Ill. 1986) (describing the business judgment standard as a "lax standard" that disturbs a debtor's actions "[o]nly where [such actions] are in bad faith or in gross abuse of its managerial discretion.").

[11] *See* In re Petur U.S.A. Instrument Co., 35 B.R. 561, 563 (Bankr. W.D. Wash. 1983); Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1047 (4th Cir. 1985) (the question is "whether the decision of the debtor that rejection will be advantageous is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice.").

contract with all of its burdens.[12] To comply with section 365(b), the debtor must cure any prior defaults and provide adequate assurance of future performance.[13] In the event that the debtor rejects an executory contract, under subsection 365(g), the nondebtor is entitled to a prepetition unsecured damages claim for breach of that contract.[14] Finally, as will be discussed below, the power granted to the debtor under 365(a) is further limited by the carve-outs described in 365(c) and 365(n), which apply when the debtor is the licensee and licensor, respectively.

B. When the Nondebtor is Licensee: Section 365(n)

Section 365(n)[15] provides an important protection to a licensee from the potentially severe consequences of having rights for which it contracted and on which it may depend suddenly yanked away by an insolvent licensor. The protection of section 365(n) was added relatively recently as part of the Intellectual Property Bankruptcy Protection Act of 1988 in response to a particularly alarming decision by the Fourth Circuit Court of Appeals.[16]

In *Lubrizol*, the debtor licensor sought to reject its non-exclusive license agreement with Lubrizol for no other reason than that its "continued obligation to Lubrizol under the agreement would hinder [its] capability to sell or license the technology on more advantageous terms to other potential licensees."[17] Meanwhile, Lubrizol argued that it would be seriously damaged by having to renegotiate with the debtor at this juncture. The Fourth Circuit was not unsympathetic, stating that "allowing rejection of such contracts … imposes serious burdens upon contracting parties such as Lubrizol."[18] It was further

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[12] 3 Collier on Bankruptcy ¶ 365.03[1] (15th ed. rev. 2006).

[13] 11 U.S.C. § 365(b).

[14] However, even if specific performance would ordinarily be available (which is unlikely in an intellectual property licensing context), it is not available with respect to a party in bankruptcy. *Lubrizol*, 756 F.2d at 1048 (citing H.R. Rep. No. 95-595, at 349 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6305) ("Under 11 U.S.C. § 365(g), [the licensee] would be entitled to treat rejection as a breach and seek a money damages remedy; however, it could not seek to retain its contract rights in the technology by specific performance even if that remedy would ordinarily be available upon breach of this type of contract.").

[15] 11 U.S.C. § 365(n).

[16] 3 Collier on Bankruptcy P 365.14 ("In enacting section 365(n), Congress effectively overruled the decision of the Court of Appeals for the Fourth Circuit in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.),* which had permitted a debtor in possession to reject a technology licensing agreement and terminate the licensee's right to use the license.").

[17] 756 F.2d at 1047.

[18] *Id*. at 1048.

concerned that such a result would "have a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty."[19] However, when a statute enacted by Congress is clear, courts will usually apply it literally, regardless of its results or questionable policy. This is what the Fourth Circuit did with section 365(a), allowing the debtor to reject the contract and leaving Lubrizol in a difficult position.

Congress could do nothing for Lubrizol, but it did mitigate the problem for future licensees in Lubrizol's position. Section 365(n) allows a licensee of "intellectual property"[20] to retain its rights under the license, at least to the extent that they do not require specific performance of affirmative obligations of the debtor.[21] Exclusive licenses remain exclusive, confidentiality agreements remain in effect, and licensees even retain any option to extend the license built into the agreement.[22] In exchange, of course, licensees must continue to pay any royalties due under the agreement.[23] Or, alternatively, if the licensee prefers to accept the debtor's rejection, it has the usual option of treating the rejection as a breach giving rise to prepetition unsecured damages claim under section 365(g).[24]

C. When the Nondebtor is the Licensor: Section 365(c)

Section 365(c) is an extraordinary provision which, when read literally, in most cases gives a licensor of patented technology the ability to refuse to honor a contract with a licensee in bankruptcy. Section 365(c) provides:

> The trustee *may not assume* or *assign* any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

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[19] *Id.*

[20] Intellectual property under the code includes patent, copyright and trade secret rights but, notably, excludes trademark rights. 11 U.S.C. § 101(35A) provides:

> The term "intellectual property" means—
> (A) trade secret;
> (B) invention, process, design, or plant protected under title 35;
> (C) patent application;
> (D) plant variety;
> (E) work of authorship protected under title 17; or
> (F) mask work protected under chapter 9 of title 17;
> to the extent protected by applicable nonbankruptcy law.

[21] 11 U.S.C. § 365(n)(1)(B).

[22] *Id.* § 365(n)(1)(B)(ii).

[23] *Id.* § 365(n)(2)(B).

[24] *Id.* § 365(n)(1)(A).

> (1)(A) *applicable law excuses a party*, other than the debtor, to such contract or lease *from accepting performance from or rendering performance to an entity other than the debtor* or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment…[25]

The provision would more readily make sense if it read, "the trustee may not assume *and* assign any executory contract…." In that case, the licensor would simply be extended the same right under bankruptcy law – to refuse performance from a party with whom it did not contract – that it had prior to the bankruptcy (assuming it had that right). But the statute reads otherwise. It says that if the nondebtor licensor objects to the assumption of the contract by the debtor, and if non-bankruptcy law excuses that licensor from accepting performance from some other (hypothetical) third-party, the debtor itself may not assume the license.

This is a severe limitation on the rights granted to the debtor under section 365(a). The pertinent non-bankruptcy "applicable law" for patent licenses is federal common law.[26] It is a well-established principle under this law that unless the terms of the agreement provide otherwise, a non-exclusive patent license is personal in nature and therefore not freely assignable.[27] This rule has been extended to exclusive licenses by at least one lower court,[28] and that court was almost certainly correct in its decision.[29] Although an exclusive license represents

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[25] § 365(c) (emphasis added).

[26] Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 679-80 (9th Cir. 1996) (holding, after lengthy analysis, that the statutory "applicable law" is federal law, and that federal law does not permit free assignment of patent licenses); Institut Pasteur v. Cambridge Biotech Corp., 14 F.3d 489, 492 (1st Cir. 1997) (same conclusion).

[27] Troy Iron & Nail Factory v. Corning, 55 U.S. (14 How.) 193, 216 (1852) ("A mere license to a party, without having his assigns or equivalent words to them, showing that it was meant to be assignable, is only the grant of a personal power to the licensees, and it is not transferable by him to another."); Lane & Boley Co. v. Locke, 150 U.S. 193, 195-96 (1883) (holding that patent licenses, as a form of personal property, are not assignable unless expressly made so); *In re CFLC, Inc.*, 89 F.3d at 679-80; *Institut Pasteur*, 14 F.3d at 492.

[28] *In re* Hernandez, 285 B.R. 435 (Bankr. D. Ariz. 2002).

[29] *See* Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, 22 Berkeley Tech. L.J. 733, 798 (2007) ("Unless the patentee has transferred so much of the patent bundle to an exclusive licensee as to constitute an assignment, it seems appropriate for a bankruptcy court to read the non-assignability of patent license rule to apply whether or not the license agreement granted exclusive or nonexclusive rights.").

a more complete transfer of rights, it is still personal in nature. It would be a serious and unjustifiable burden to ask a patentee to accept performance on an exclusive license from a competitor who sought to suppress rather than exploit the invention. Of course, the code is correct to honor this right under federal common law. But it does not follow that patentees should be free to reject performance from the debtor itself. The terms of section 365(c)(1) allows a licensor, at its whim, to force a renegotiation of terms of access to patented technology to which the debtor had already secured a right. This flies in the face of the core bankruptcy policy in favor of maximizing the value of the estate. Nevertheless, many courts have felt constrained to follow this "plain meaning" of the statute.

This literal interpretation of section 365(c) is usually called the "hypothetical test." The test asks whether the licensor would be excused from doing one thing (acquiescing to assignment to a hypothetical third party) in order to determine whether it is excused from doing another (acquiescing to assumption). The Third, Fourth, Ninth, and Eleventh Circuits take the "hypothetical test" approach.[30] This approach has the merits of leaving lawmaking to a representative elected body and of holding Congress to its words.[31] Plain meaning dogmatists would also claim that it has the advantage of predictability since anyone can read the statute and know what it means without delving deep into the case law or engaging in some kind of mystical divination of Congressional purpose.[32]

Such a divination was attempted by the First Circuit Court of Appeals in *Summit Inv. & Dev. Corp. v. Leroux.*[33] The court in this case looked to two pieces of statutory history[34] to justify the conclusion that subsection 365(c) – and, more to

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[30] Third Circuit: *In re* W. Elec., Inc., 852 F.2d 79 (3d Cir. 1988); *see alsoIn re* Access Beyond Techs., Inc., 237 B.R. 32 (Bankr. D. Del. 1999).

Fourth Circuit: RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 262 n.9 (4th Cir. 2004); *see also In re* Travelot Co., 286 B.R. 447 (Bankr. S.D. Ga. 2002).

Ninth Circuit: Perlman v. Catapult Entm't (*In re* Catapult Entm't), 165 F.3d 747, 747 (9th Cir. 1999).

Eleventh Circuit: City of Jamestown v. James Cable Partners, L.P. (*In re*James Cable Partners, L.P.), 27 F.3d 534, 537, *reh'g denied*, 38 F.3d 575 (11th Cir. 1994).

[31] *See In re* Catapult Entm't, 165 F.3d at 754.

[32] It is the view of this author that the rigid application of statutory nonsense is more likely to result in outrage and confusion than comfortable predictability.

[33] 69 F.3d 608 (1st Cir. 1995).

[34] S. Rep. No. 95-989, at 59 (1978), *reprinted in* 1980 U.S.C.C.A.N. 5787, 5845 ("This section will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or a lease, the court will have to ensure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain."); H.R. Rep. No. 95-1195, at § 27(b) (1980)

the point in *Leroux*, 365(e) as well[35]– contemplates a "case-by-case inquiry" into whether the nondebtor party was actually being forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.[36] This approach is referred to as the "actual test."

Before looking to statutory history, the court in *Leroux* concluded that 365(c) is ambiguous and capable of alternative readings.[37] It is not true that 365(c) alone is ambiguous. It speaks clearly. However, as has been noted by advocates and courts, section 365(f) conflicts with section 365(c).[38] Section 365(f)(1) provides:

> Except as provided in subsections (b) and (c) of this section, *notwithstanding a provision* in an executory contract or unexpired lease of the debtor, or *in applicable law*, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.[39]

That 365(f) allows the assignment of contracts *notwithstanding applicable law* indicates a drafting error. Section 365(f)(1) is conditioned on 365(c), and 365(c) expressly prohibits both assumptions and assignments when they are

("This amendment makes it clear that the prohibition against the trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal nature of the contract.").

[35] Section 365(e) mirrors 365(c):

> (e) …
>
> (2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
>
> (A)
>
> (i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (ii) such party does not consent to such assumption or assignment; …

[36] 69 F.3d at 612-13; *see also* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997), *cert. denied*, 521 U.S. 1120 (1997) (following and applying the *Leroux* interpretation of 365(c) with respect to an executory nonexclusive patent license).

[37] 69 F.3d at 612-13.

[38] Perlman v. Catapult Entm't (*In re* Catapult Entm't), 165 F.3d 747, 751 (9th Cir. 1999); *In re* Catron, 158 B.R. 629, 636 (E.D. Va. 1993), *aff'd*, 25 F.3d 1038 (4th Cir. 1994); *In re* Cardinal Indus., Inc., 116 B.R. 964, 976-77 (Bankr. S.D. Ohio 1990).

[39] 11 U.S.C. § 365(f)(1) (emphasis added).

excused by *applicable law*. Thus, 365(f)(1), by way of 365(c)(1), renders itself superfluous.[40] One or the other provision is in error. But the way the statute conflicts does not lead logically to the conclusion that the "actual test" is correct. Policy intuition, on the other hand, does lead to this conclusion. The actual test does not unduly burden the estate by permitting a hold-up style renegotiation, and it also does not force a patentee to accept performance from a third party where federal common law would excuse it. It is in keeping with sound bankruptcy policy and, not surprisingly, it is the test favored by respected commentators and academics.[41]

Of course, from a licensor's point of view, the hypothetical test is preferable to the actual test. It has the virtue of insuring the nondebtor against being locked into an agreement with a partner who is only marginally viable, or whose management or ownership has changed in a way that is disagreeable to the licensor.[42] Particularly for a patentee who has granted an exclusive license, and thereby promised not to license the technology to another party, the burden of having to accept performance from a defunct partner is substantial.[43] That these burdens probably do not justify the terms of 365(c) as Congress drafted it,[44] and that not all courts apply the hypothetical test, should give pause to a potential licensor. The area of law is unstable and probably not to be depended upon.

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[40] Attempts to reconcile the provisions are thoroughly unconvincing. *SeeIn re* Catapult Entm't, 165 F.3d at 751, and cases cited therein.

[41] *See* David G. Epstein, Steve H. Nickles & James J. White, Bankruptcy § 5-15, at 258-59 (1993) (advocating that "Congress should amend section 365(c)(1) to make clear that 'applicable law' prohibitions on assignment do not preclude assumption in bankruptcy" and urging courts to permit a trustee or debtor to assume a contract notwithstanding a prohibition on assignment in the "applicable law" so as to ensure a harmony between subsections (c) and (f) of section 365); 3 Collier on Bankruptcy ¶ 365.06[1][d][iii]; Daniel J. Bussel & Edward A. Friedler, The Limits on Assuming and Assigning Executory Contracts, 74 Am. Bankr. L.J. 321, 322 n.6 (2000) (arguing that the "'actual test' yields correct results from the point of view of bankruptcy policy and allows results in bankruptcy to effectively mirror the results outside of bankruptcy").

[42] For example, a provision in the non-exclusive license in *Institute Pasteur* allowed a competitor of the patentee to gain access to the patentee's coveted technology by acquiring the debtor. 104 F.3d at 494-95.

[43] A patentee has limited time to commercially exploit her patent. Section 154(c)(2) of the Patent Act provides that the patent term begins when the patent is issued and ends 20 years from the date that the patent application was filed. Since it take years to procure a patent from an overburdened patent office, patent terms are typically considerably fewer than 20 years.

[44] Congress, in overriding *ipso facto* clauses in section 365(e), has expressed the view that, in general, the burden to a nondebtor party of having to accept performance from or render performance to a party in bankruptcy is outweighed by the need to maximize the value of the estate and to rehabilitate the debtor.

In fact, at least one court in a "hypothetical test" jurisdiction has allowed a work-around solution to the debtor's 365(c) problem. In *In re Hernandez*,[45] the court permitted the debtor to intentionally neglect to accept or reject an exclusive license agreement under 365(a) so that the license would simply "ride through" the bankruptcy unaffected.[46] The so called "ride through" doctrine has been approved by courts of appeals in other contexts[47] and could provide an effective shield for debtor licensees against 365(c). The major drawback from the debtor's perspective is that since the contracts are not accepted under 365(a), the protection against *ipso facto* clauses in 365(e) does not apply.[48]

III. CONCLUSION

What lessons can we learn from the material just surveyed? As a nondebtor licensee, it would be helpful to structure an agreement as an assignment when possible, since an assignee is beyond the reach of the bankruptcy court. However, when this is not a realistic option, the licensee's rights are reasonably well protected by section 365(n). The only further precaution that might be helpful is to provide for the option to extend the length of the agreement, since these options will be honored by a bankruptcy court.

As a licensor, it is advantageous to have the agreement in the form of an executory contract. This is because section 365(c) allows for at least some continuing control over the technology. In a jurisdiction where the "actual test" is followed, the licensee will be prevented from assigning the license without the licensor's consent. In a "hypothetical test" jurisdiction, the licensor will have the right to refuse performance even from the licensee. Executory contracts include practically all licenses agreements in most jurisdictions, but it would be helpful to have at least some of the licensee's payments in the form of royalties, rather than a single lump sum. Specifying any other significant ongoing obligations imposed on the licensor would also be helpful. Finally, in order to avoid a "ride-through" situation, a licensor should include an *ipso facto* clause in the contract.

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[45] 287 B.R. 795 (Bankr. D. Ariz. 2002).

[46] *Id*.

[47] *See, e.g.*, Stumpf v. McGee (*In re* O'Connor), 258 F.3d 392 (5th Cir. 2001), and cases cited therein.

[48] *See* 11 U.S.C. § 365(e)(1).

FASTEN YOUR SEATBELTS, IT'S GOING TO BE A BUMPY NIGHT: THE IMPLICATIONS OF RECENT DELAWARE CASE LAW ON THE FILM INDUSTRY

JASON TYLER*

Recently, the Court of Chancery in eBay v. Newmark doubted the ability of firms to cite a threat to corporate culture as legitimate grounds for implementing a takeover defense. Just over a year ago, the Court in Amylin expressed doubt about a firm's ability to impede changes of control by embedding financial penalties, for lack of a better word, in otherwise ordinary business transactions. Jason Tyler argues that Hollywood presents an exceptional context, or, to put it another way, that the economic reality of movie studios pushes at the logical assumptions that underlie the eBay and Amylin holdings. Accordingly, if applied broadly, eBay and Amylin may threaten movie studios in particular.

I. INTRODUCTION

Applying general corporate law principles to Hollywood is challenging because the film industry is unique. This article attempts to offer some preliminary analysis of two recent Delaware[1] Court of Chancery cases dealing with contests for corporate control in light of Hollywood's unique qualities. Recently, the Court of Chancery in *eBay v. Newmark* doubted the ability of firms to cite a threat to corporate culture as legitimate grounds for implementing a takeover defense.[2] Just over a year ago, the Court in *Amylin* expressed doubt about a firm's ability to impede changes of control by embedding financial penalties, for lack of a better word, in otherwise ordinary business transactions.[3] In both cases, the final analysis proceeded naturally from a central tenet of Delaware's corporate law

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[1] Nearly one million business entities and more than half of the corporations making up the Fortune 500 list were incorporated in Delaware as of 2007. Lewis B. Black, Jr., Why Corporations Choose Delaware 1 (2007), *available at* Delaware Department of State, Division of Corporations, http://corp.delaware.gov/default.shtml. For each of these Delaware-chartered entities, Delaware corporate law applies. *See* 18 William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Corporations §43.72 (perm. ed., rev. vol. 2007) (Defining "Internal Affairs" doctrine). Accordingly, referring to Delaware common law – as opposed to a 50-state survey – is convenient shorthand applicable to most businesses.

[2] Civ. No. 3705-CC, 2010 WL 3516473 (Del. Ch. Sept. 9, 2010).

[3] 983 A.2d 304 (Del. Ch. 2009), *aff'd* 981 A.2d 1173 (Del. 2009).

jurisprudence: ultimate authority to elect corporate directors rests in the hands of the shareholders as the principals of their agent-directors.

This article expresses no opinion on the ultimate dispositions of those cases in their respective factual contexts or on the merits of the particular litigants' arguments. Rather, this article argues that Hollywood presents an exceptional context, or, to put it another way, that the economic reality of movie studios pushes at the logical assumptions that underlie the *eBay* and *Amylin* holdings. Accordingly, if applied broadly, *eBay* and *Amylin* may threaten movie studios in particular. Where possible, this article further offers a preliminary attempt to interpret *eBay* and *Amylin* in a way that would militate such a threat.

II. "ALL RIGHT, MR. DEMILLE, I'M READY FOR MY CLOSE-UP": MOVIEMAKING MICROECONOMICS

While the film industry is unique in numerous ways of course, two of its characteristics are often underemphasized. First, movie studios enjoy only nominal brand identification. To be sure, the public recognizes the names of the Big Six studios (Disney, Fox, Paramount, Sony, Warner Brothers, and Universal) and often so-called "mini-majors" (e.g., Lionsgate, MGM, The Weinstein Company/Dimension Films). Yet, perhaps with the exception of Disney (and its subsidiary Pixar), the public rarely goes to a movie *because* it is produced or distributed by a certain studio. Instead, audiences decide to see one movie or another because of factors germane to the particular movie itself, such as what it's about, who's in it, who directed it, how well it's been reviewed, etc. Accordingly, studios' market share greatly fluctuates from year-to-year and is attributable more to that year's slate of releases than to the established brand of the studio.[4]

Second, and correlatively, a movie studio's financial success thus depends largely on the qualitative taste of key production executives, often including the studio's chief executive officer, who "green light" or acquire prospective projects for production and distribution. That is, if the studio's market share and revenue derive afresh each year from the public's appetite for particular releases, then the executives who decide *what* to release bear significant responsibility for ensuring the studio's success.[5]

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[4] Harold L. Vogel, Entertainment Industry Economics: A Guide for Financial Analysis 57 (6th ed. 2004).

[5] I realize it is naïve to assume a studio's financial health derives solely from production, acquisition, and direct distribution of film and television projects. Studios derive considerable financial benefit as well by, *inter alia*, exploiting libraries of past film properties, entering into favorable co-financing agreements that reduce costs of capital, and acting as sales agents or

Consequently, one may assume stakeholders – i.e., equity and debt investors – are relatively more concerned with preserving extant corporate culture and retaining key employees when investing in a movie studio than when investing in any other going concern. This, too, is a unique aspect of the film industry, but one which Delaware corporate law apparently does not recognize.

III. "YOU ARE NOT A BEAUTIFUL AND UNIQUE SNOWFLAKE": *EBAY V. NEWMARK*

eBay v. Newmark concerned eBay's star-crossed investment in craigslist, a relationship that Chancellor Chandler described as "oil and water."[6] Craig Newmark and Jim Buckmaster – the founder and CEO of craigslist, respectively, and its controlling shareholders, collectively – wanted to continue operating their business as a community service.[7] In contrast, eBay – the third, minority shareholder – wanted to monetize the service as soon as its investment was finalized.[8] Thus, a culture clash: "It might be said that 'eBay' is a moniker for monetization, and that 'craigslist' is anything but."[9]

Driving the dispute more specifically, Newmark and Buckmaster retaliated against eBay for launching a competitive online classified service ("Kijiji") by, *inter alia*, implementing a stockholder rights plan (more commonly known as a "poison pill") that restricted eBay's ability to sell its craigslist shares to third parties.[10] As a takeover defense, the rights plan was subject to the *Unocal* standard, which requires the company to show (1) a reasonably perceived threat to corporate policy and effectiveness and (2) that the defensive tactic is a reasonable response to that threat.[11]

In *Paramount Communications, Inc. v. Time Inc.* (hereinafter "*Time-Warner*"),[12] the Delaware Supreme Court famously held that defensive action to

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performing other services within the industry. Nevertheless, I ignore these aspects of a studio's business for the sake of simplicity.

[6] eBay Domestic Holdings, Inc. v. Newmark, 2010 WL 3516473, at *2 (Del. Ch. Sept. 9, 2010).

[7] *Id.* ("Though a for-profit concern, craigslist largely operates its business as a community service. Nearly all classified advertisements are placed on craigslist free of charge. Moreover, craigslist does not sell advertising space on its website to third parties. Nor does craigslist advertise or otherwise market its services. craigslist's revenue stream consists solely of fees for online job postings in certain cities and apartment listings in New York City.")

[8] *Id.* at *7.

[9] *Id.* at *3.

[10] *Id.* at *9-15.

[11] *Id.* at *21; Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985).

[12] 571 A.2d 1140 (Del. 1990) [*hereinafter "Time-Warner"*].

protect a target's corporate "culture" could satisfy the first *Unocal* prong. In *eBay*, however, Chancellor Chandler cabined craigslist's ability to rely on the "amorphous purpose of 'cultural protection' as a justification for defensive action…"[13] Indeed, he found nothing unique to craigslist's community-service-oriented operation:

> "Giving away services to attract business is a sales tactic, however, not a corporate culture. … To the extent business measures like loss-leading products, money-back coupons, or putting products on sale are cultural artifacts, they reflect the American capitalist culture, not something unique to craigslist."[14]

Accordingly, with nothing unique about craigslist's culture, there could be no reasonably perceived threat to it under *Unocal*.[15]

What makes *eBay* troubling for a movie studio looking to implement a takeover defense is the Court's use of the word "unique." The Chancellor found craigslist's culture was not unique and, therefore, its controlling shareholders could not rely on corporate culture as grounds for implementing a takeover defense. But exactly *how unique* must a business be? On the one hand, it could be argued that a movie studio derives its market edge from a unique corporate culture in which key employees put their qualitative taste to task. Change the corporate culture to one where those same employees cannot similarly employ their qualitative taste and presumably there will be a change to the studio's financial performance. Thus, stakeholders looking to maximize their returns might very well want to preserve their investment's corporate culture. On the other hand, it could be argued

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[13] *eBay*, 2010 WL 3516473, at *21.

[14] *Id.* at *22.

[15] Chancellor Chandler's ruling further turned on the legal ability to assert a corporate culture of eschewing shareholder wealth maximization altogether: "*Time*[-*Warner*] did not hold that corporate culture, standing alone, is worthy of protection as an end in itself," rather a protectable corporate culture "must lead at some point to value for stockholders." *Id.* at *21. Whatever beliefs Newmark and Buckmaster might have had about community service, they

> "opted to form craigslist, Inc. as a *for-profit Delaware corporation* and voluntarily accepted millions of dollars from eBay as part of a transaction whereby eBay became a stockholder. Having chosen a for-profit corporate form, the craigslist directors are bound…to promote the value of the corporation for the benefit of its stockholders. … Thus, I cannot accept as valid for the purposes of implementing the Rights Plan a corporate policy that specifically, clearly, and admittedly seeks *not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders…"

Id. at *23 (emphasis in original). This line of reasoning, however, is not relevant to this article, because most movie studios *are* interested in profit maximization and are thus easily distinguishable from craigslist.

that *all* movie studios rely on a culture in which qualitative decision-making on matters of taste are encouraged. Thus, there would be nothing unique about any *one* studio's corporate culture.

Time-Warner itself offers little guidance. There, Time sought to preserve its "journalistic integrity," a quality that perhaps all news organizations share, because "Time's management made a studious effort to refrain from involvement in Time's editorial policy," a quality that may be unique to Time even within the industry.[16] Moreover, there is an inter-industry component that complicates the *Time-Warner* analysis: Time feared its focus on journalism was threatened by a merger with an entertainment company (either Paramount, a hostile bidder, or Warner Bros., a friendly bidder that had promised to preserve Time's journalistic integrity).[FN17] In summary, Time tried to preserve a culture that may have been unique to it and, even if that culture were ubiquitous in the news industry, would be unique in the entertainment industry. In either case, the facts of *Time-Warner* do not on their own delineate the bounds of what precisely satisfies a reasonable threat to corporate culture under *Unocal*'s first prong.

For the avoidance of doubt, it is not inconceivable for an acquiror (hostile or friendly) to seek control of an entertainment company despite failing to have prior experience in the industry. Indeed, one could seek control of an entertainment company precisely to *diversify* extant investments. For example, of the Big Six studios, Fox, Paramount, and Warner Brothers are subsidiaries of journalism/media conglomerates (News Corp, Viacom, and Time-Warner, respectively), Sony is a subsidiary of an electronics manufacturer, and Universal is a subsidiary of General Electric, which deals in energy, consumer and industrial manufacturing, and capital finance. (Disney, meanwhile, has become a parent conglomerate that owns various media, theme park, and other diverse subsidiaries.) Moreover, Carl Icahn, whose self-stated expertise is in shrewd investing and increasing management accountability,[17] has in the last two years twice launched hostile takeover bids for Lionsgate[18] and has recently offered to buy MGM's debt before its imminent

[16] *Time-Warner*, 571 A.2d at 1144 n.4.

[17] *See* Barbara Kiviat, *10 Questions for Carl Icahn*, Time, Feb. 15, 2007, *available at* http://www.time.com/time/magazine/article/0,9171,1590446-1,00.html.

[18] *See, e.g.*, Andrew Ross Sorkin, *Lions Gate Rejects Latest Icahn Offer*, N.Y. Times, Mar. 23, 2010, *available at*http://dealbook.blogs.nytimes.com/2010/03/23/lions-gate-rejects-latest-icahn-offer/ (regarding Icahn's March 2010 takeover attempt); Lions Gate Entertainment Corp., General Statement of Acquisition of Beneficial Ownership (Schedule 13D/A) (Mar. 12, 2009) (disclosing Icahn's March 2009 takeover attempt).

Chapter 11 bankruptcy.[19] Given this state of affairs, the viability of satisfying *Unocal*'s first prong by citing a threat to corporate culture is indeed relevant to studios wishing to maintain their corporate independence.

IV. "CARPE DIEM. SEIZE THE DAY, BOYS. MAKE YOUR LIVES EXTRAORDINARY": *AMYLIN*

Because movie studios rely so heavily on the taste of current employees, stakeholders who believe in extant operations have an interest in ensuring that the studio retains key employees. A change of control, however, usually ends top executives' employment.[20] Ordinary takeover defenses may satisfy such stakeholders' concerns, but they are not the only means of doing so. Debt investors, for example, are equally satisfied by "change of control provisions," covenants that accelerate the repayment of principal in the event of a change of control. Indeed, change of control provisions are relatively common in the film industry. For example, when Carl Icahn attempted to takeover Lionsgate in the spring of 2009 and again in the spring of 2010, Lionsgate cited change of control provisions in its revolving credit facility with JP Morgan Chase as a principal reason why Icahn's takeover would harm the company.[21]

Moreover, with a higher degree of certainty as to the future operations of an otherwise unstable studio, creditors are willing in turn to offer the studio more favorable financial terms in the debt agreement, thus introducing an element of bilateral exchange into the equation. Accordingly, Change of control provisions are not obviously takeover defenses, because the process occurs as part of a

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[19] *See, e.g.*, Michael Speier, *Icahn Makes Offer to Buy More MGM Debt to Expedite Merger*, Deadline Hollywood, Oct. 21, 2010, *available at* http://www.deadline.com/2010/10/icahn-makes-offer-to-buy-more-mgm-debt-to-expedite-merger/.

[20] *See* William J. Carney, Mergers & Acquisitions: Cases and Materials 307 (2d ed. 2007) (citing empirical evidence that 50% of top executives leave their employment within three years of a change of control); *cf., e.g.*, James F. Cotter & Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J. Fin. Econ. 63, 88-94 (1994) (offering empirical support that managerial resistance to tender offers appears driven by self-interest); Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. Fin. 671, 677 (1991) ("The dramatic increase in the turnover rate of top managers following takeovers…indicates that takeovers are an important device for altering the top management of target firms").

[21] *See, e.g.*, Press Release, Lions Gate Entertainment Corp., Lionsgate Board of Directors Expresses No Opinion and Remains Neutral Toward Icahn's Unsolicited Debt Tender Offer, Strongly Urges Noteholders to Consider All Aspects of Icahn's Offer Carefully (Mar. 26, 2009), *available at* http://investors.lionsgate.com/ (follow hyperlink to Press Releases, News Releases; then follow hyperlink to New Release of 3/26/2009).

seemingly ordinary business transaction. Of course, the effect on takeovers is the same: the studio derives a financial benefit precisely because of the impediment to changes of control the provisions by definition engender. In this sense, a change of control provision is an example of what may be called generally an "embedded defense."[22]

The Delaware courts have never ruled directly on the legality of embedded defenses, however the Court of Chancery did suggest last year how it might address an embedded defense challenge in *San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*[23] In *Amylin*, the company had issued bonds under an indenture that included a change of control provision prohibiting a turnover of the majority of the board, unless the outgoing board "approved" newly elected directors.[24] When two dissident shareholders launched proxy contests, the incumbent board "approved" the dissident slates for purposes of the indenture while running its own opposing slate in the same election.[25] The noteholders' trustee brought suit, claiming that the plain meaning of "approve" should have precluded Amylin from "approving" directors of whom it necessarily disapproved via the voting franchise.[26]

Vice Chancellor Lamb upheld the board's actions and disagreed with the trustee's interpretation because such a reading would render the change of control provision an "entrenchment mechanism . . . prohibit[ing] *any* change in the majority of the board as a result of any number of contested elections, for the entire life of the notes."[27] Other facts surrounding the negotiation of the indenture undermined such a reading.[28] The Vice Chancellor then added in dicta that

"[a] provision in an indenture with such an eviscerating effect on the stockholder franchise would raise grave concerns… The court would want, at a minimum, to see evidence that the board believed in good faith that, in accepting such a provision, it was obtaining in return extraordinarily valuable economic

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[22] Professors Arlen and Talley coined the term "embedded defenses" in Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. Pa. L. Rev. 577, 583 (2003).

[23] 983 A.2d 304 (Del. Ch. 2009), *aff'd* 981 A.2d 1173 (Del. 2009).

[24] *Id.* at 307-308.

[25] *Id.* at 312-13.

[26] *Id.* at 314.

[27] *Id.* at 315 (emphasis in original).

[28] In particular, the court focused on a second credit agreement with a bank, conceded by all parties to be more restrictive than the indenture, but not susceptible to a similar interpretation as the trustee's interpretation of the indenture. *Id.*

benefits for the corporation that would not otherwise be available to it. Additionally, the court would have to closely consider the degree to which such a provision might be unenforceable as against public policy."[29]

Perhaps complicating the court's reasoning, it is important to keep in mind that Vice Chancellor Lamb did not invalidate the change of control provision itself, only the trustee's *interpretation* of it. Moreover, the Court upheld a second change of control provision in another debt agreement in that same case.[30]

It appears that neither the Delaware courts nor corporate law scholars have come to a consensus on the meaning of *Amylin*. So far it has been cited in subsequent case law only for certain contract law authority and a cursory search on Westlaw and SSRN produced no commentary. *Amylin*'s implication seems daunting, however: a change of control provision triggered by a change in the composition of the board would be considered invalid under Delaware corporate law except, perhaps, if the company received "extraordinarily valuable economic benefits" in exchange.

Inherently unstable operations like movie studios might be best able to exploit the exception since, as discussed above, they receive more favorable financial terms in exchange for the covenant. Nevertheless, the studio would have to show "*extraordinarily* valuable economic benefits," not simply some economic benefit, in order to satisfy *Amylin*'s standard. I can only speculate as to the meaning of "extraordinary" in this context, however I doubt Vice Chancellor Lamb would have gone to such extremes if a mere reduction of the applicable interest rate would suffice.

Despite the seemingly high standard Vice Chancellor Lamb would require, the case is susceptible to a more nuanced interpretation than it would seem at first glance. In *California Public Employees' Retirement System v. Coulter*,[31] for example, Vice Chancellor Noble noted that parties employing a continuing director provision, like the one involved here, bargain for the right, "as a matter of contract, to allow the incumbent directors…to determine [that] there had not been a change of control." In *Amylin*, Vice Chancellor Lamb similarly observed in a footnote that the directors possessed only a contractual right and were "under absolutely *no* obligation to consider the interests of the noteholders in [exercising that right.]"[32] Synthesizing this language, a reasonable interpretation of *Amylin* is

[29] *Id.* (internal citations omitted).
[30] *Id.*
[31] No. Civ.A. 19191, 2005 WL 1074354, at *4 (Del. Ch. 2005).
[32] *Amylin*, 983 A.2d at 316 n.37 (emphasis in original).

that the trustee's contractual reading would have violated Delaware public policy not because all change of control provisions are impermissible *per se*, but because the trustee's interpretation would transform a contractual term generally interpreted as conferring a discretionary *right* to be exercised in accordance with directors' fiduciary duties into a committed *obligation* notwithstanding any adverse effects on shareholders. That is, a change of control provision intended to allay creditors' concerns may be enforceable where it confers a benefit on shareholders (e.g., by reducing the company's cost of capital), but not where it is contrary to shareholders' best interests (e.g., by impeding the voting franchise). Concededly, this interpretation derives from a close, subtle reading of the Vice Chancellor's language, however it would permit studios – and all businesses – both (1) to agree to change of control provisions that reduce the studio's cost of capital at the inception of the agreement and (2) to refuse to exercise that contractual right (i.e., to permit acceleration to occur) as a way to discourage a hostile takeover when the board believes in good faith that the change of control would not be in shareholders' best interests (i.e., consistent with its fiduciary duties under *Unocal*).

V. "GOOD NIGHT, AND GOOD LUCK": CONCLUSION

eBay and *Amylin* are troubling cases for movie studios because both undermine extant Hollywood practices: after *eBay*, it is increasingly difficult for movie studios to rely on threats to corporate culture as reasonable grounds for implementing a takeover defense; after *Amylin*, it may be harder to allay creditors' fears of volatility by offering common change of control provisions as an escape mechanism from the investment in the event of volatility. But these practices make *business* sense for movie studios in a way that might not for other industries: corporate culture is salient where revenue depends on taste; change of control provisions are beneficial where the risks of key executive turnover would otherwise make capital prohibitively expensive.

"What we've got here is a failure to communicate."